Research Center of
the Institute for Privatization and Management

German Economic Team in Belarus

PP/07/03

Recommendations for Improving the Effectiveness of Mortgage Banking in Belarus – The Refinance Side

Summary

Mortgage lending is of crucial importance for the country's economic development. In Belarus, mortgage lenders face severe difficulties in obtaining the necessary refinancing to provide mortgage loans. Thus, this business is still underdeveloped. In this paper we put forward several proposals to avoid worsening and to improve the refinancing situation of mortgage lenders (banks). We analyze possible sources of banks' refinancing and conclude that the capital market is the most desirable one. We recommend favouring the establishment of a system based on mortgage bonds, rather than on mortgage backed securities. The latter system is too complex to be implemented in Belarus for the foreseeable future and the likelihood of it being successful is low. Then, we propose the introduction of legal safety requirements for mortgage bonds. This will create an attractive asset class and thus increase the demand for mortgage bonds by private and institutional investors as well as government institutions. At last we think that a universal banking principle in the field of mortgage lending should be maintained in order to avoid a shrinking volume of mortgage loans.

Contents

76 Zakharov Str., 220088 Minsk, Belarus. Tel./fax: +375 (17) 236 11 47, 236 43 95
E-mail: bmer@ipm.by, Internet: http://ipm.by/ic

1. Introduction

The system of mortgage lending is one of the key elements of an economic system. The most important economic objective is to supply a sufficient amount of capital for house building. To achieve this long-term capital must be attracted and be channeled into the housing finance market. When constructing an efficient system we face lots of aspects: government's participation in the process, juridical problems (property rights, valuation of property etc.), land law perspectives, macroeconomic effects and many others. The first and most important step is to choose between strategic options. Thus in this paper we focus on refinancing aspects of mortgage lending. We will analyze possible sources of refinancing and their expediency for Belarus. We will answer which way of refinancing through capital markets is most appropriate for Belarusian banks and why; which problems can be solved using this system and which cannot. We will argue about the measures needed to strengthen the mortgage lending system in terms of stability and safety.

The structure of the paper is as follows: In Chapter 2 we discuss problems to be solved in the Belarusian housing finance system. In Chapter 3 we describe two refinancing systems based on capital markets: The systems of mortgage bonds (MB) and of mortgage backed securities (MBS). In Chapter 4 we try to distinguish the system that is more appropriate for Belarus, whereas in chapter 5 the question is detailed whether a universal or a special banking principle is more in demand for Belarus. In Chapter 6 we substantiate necessary safety-restrictions for such a system. Afterwards we summarize all previous conclusions and give our solutions for a systematic development of mortgage lending.

2. Problem Setting and Issues for Further Analysis

During the period 1996 till 2002, 21,888,000 square meters were built while the official turn for improving housing reduced only from 613,000 people to 556,000. The number of apartments completed stagnated (about 3,000 square meters per year) and is regarded as insufficient by the public and the authorities.

The current system of housing finance in Belarus is characterized by a large influence of subsidies and favorable (government supported) loans. For instance, the share of favorable loans in all loans to private households by Belarusbank, was 90.9% in 2001. The share of (commercial) loans for real estate financing with non-favorable conditions was only 2.6%. But the government plans not to keep on financing the budget deficit through NBB. So the refinancing of banks through the National Bank is going to decrease. Therefore the main problem to be solved is discovering other sources of refinancing in order to substitute the existing ones and to overcome the capital shortage for housing.

Generally the following possible resources of banks' refinancing exist: First, central bank and inter-bank credit, second, bank deposits and third, capital market instruments. Credit from the central bank means expanding the monetary base and eventually leads to higher inflationary pressure. It doesn't channel private savings as investments into the housing market. But however we do not deny the necessity of government's subsidies for housing, but regard the current system of funding (central bank credit) as ineffective and inefficient. Also inter-bank credit is just a shift of funds between banks and so doesn't answer the question where funds for housing eventually come from.

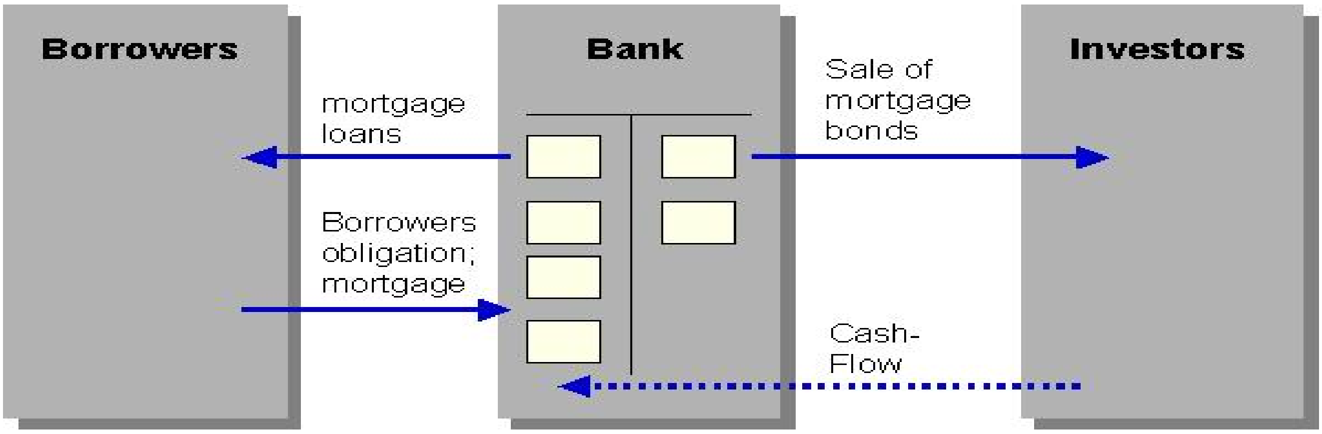
The second source of refinancing mortgage lending are bank deposits. But we are skeptical about this possibility in Belarus, because the volume of long-term deposits, which are needed for long-term bank lending, is underdeveloped. Attracting long-term deposits works only in stable economic conditions with low inflation.

The third way of refinancing is the capital market. Agents like insurance companies, pension funds etc. make long-term investments. And if incentives were created for institutional investors to channel their assets into the housing finance market, the sharpness of the problem (insufficient supply of capital) would be mitigated. For accomplishing this task, a secure tool should be created that is an investment vehicle and at the same time a funding tool for banks. There are two main tools satisfying these requirements: mortgage bonds (MB) and mortgage backed securities (MBS).

3. Mortgage Bonds (MB) and Mortgage Backed Securities (MBS) as two Alternatives

The mortgage bond system is used in many European countries such as Germany and consists of three participants: mortgage borrowers, mortgage lenders (banks) and investors. First, mortgage banks provide loans to mortgage borrowers. The mortgage banks sell mortgage bonds for refinance reasons. (see chart 1). A schematic circuit of mortgage bonds is the following.

Chart 1: The Mortgage Bond System.



Generally mortgage lending includes four aspects: funding, originating, holding and servicing the mortgage. The three latter aspects still remain with a bank. But MBs enable to solve the main problem of banks' refinancing. The right to issue mortgage bonds gives banks an effective funding instrument to be bought by investors.

So having stressed the lack of funds as the main problem at the housing finance market, we may state that MBs involve a new market player (the bond investor), that otherwise would not operate in this market.

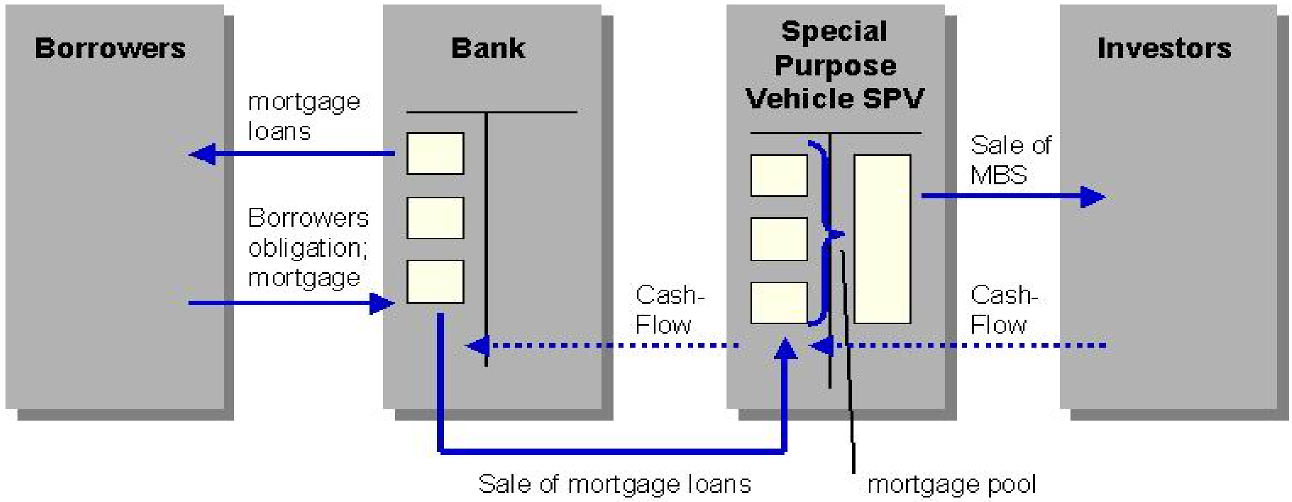
Further we can identify advantages and disadvantages for each agent in the MB system: Mortgage bonds allow matching the maturities of a bank's assets (loans) and liabilities. This removes liquidity risk for a bank and hence reduces the liquidity-risk premium. Then the main advantage for a borrower should be a more affordable interest rate. Besides, in this case mortgage loans will be more available due to the inflow of funds to the housing finance market. Some negative moments from the borrower's side will be connected with rather strict conditions of granting a loan. In this system a bank is still the main market agent who is exposed to credit risk[1]. So in an MB system banks will be interested in lowering the risk. This will result in careful monitoring the borrower's income and solvency in order to keep up the payment-to-income ratio at an acceptable level. An additional advantage for banks would be to have one more tool for conducting a profitable business with relatively low risk. The drawback of the system from a bank's point of view will be credit risk exposure – mortgage loans remain on the bank's balance sheet. The combination of the safety of the instrument and its liquidity will attract institutional as well as private investors. Especially when it has a better credit quality than bank deposits and/or a higher yield-to-maturity than government securities. (For instance the German example shows that mortgage bonds have a yield spread of 20-50 basis points over government bonds).

The alternative to mortgage bonds are mortgage backed securities (MBS). Chart 2 shows the schematic circuit of the mortgage backed securities system.

The mortgage backed securities (MBS) system features a fourth participant, the so-called special purpose vehicle (SPV) or conduit vehicle. The banks sells mortgage loans to the SPV, where they are bundled and securitized into MBS and sold to investors. Banks are thus able to sell the mortgage loans to the investors (via SPV) and to clear the balance sheet.

[1] In contrast to credit risk we consider interest rate risk as exogenous that cannot be removed by internal factors. In the case of MB the bank and investor will divide this kind of risk.

Chart 2: The Mortgage Backed Securities System



We must clarify the role of the SPV in the MBS system and the changes it generates to mortgage market. The SPV is not a financial institute but just a legal construction. Usually SPV are stockholder companies or limited liabilities companies. In some countries, notably the USA, the government supports an agency that creates SPV and MBS. It buys mortgages from mortgage originators (i.e. banks, mortgage brokers) and forms a pool of these mortgages. Actually this is a process of transferring mortgage ownership, i.e. a step of mortgage bundling/unbundling – the function of mortgage holding since then is accomplished by the SPV. The Bank becomes an agent that actually fulfils an operation of underwriting and basing on it the SPV purchases relatively safe mortgages. Next step is a securitization of mortgages into mortgage backed securities, which begin to play a role of a medium of circulation at the secondary mortgage market. In comparison to the MB system the MBS system enables further re-allocation of risk. Risk here moves to the investors. An MBS-system allows that the risks are hold by those that are most willing to hold it. Not clear. Remove it.

The main economic advantage of the MBS-system is that it unbundles the four aspects of mortgage lending. Especially the allocation of risks can be more efficient. From an operational point of view, for banks the main advantage of a MBS system vis-a-vis a mortgage-bond system is freeing equity capital for new loans.

4. Mortgage Bonds or MBS? Strategic Recommendations for Belarus

As stated above the most reasonable source of refinancing for the Belarusian banks should be the capital market. So we should make a strategic choice between either the MB or the MBS system. When making a choice there should be an awareness of investors' incentives for purchasing mortgage securities in Belarus.

We suppose that in Belarus safety will be the strongest impulse for investing. The main advantage of the MB system is an incentive for banks to keep high safety requirements. The banks are at the same time agents of risk holding and servicing in the MB system. That is why they have an incentive to reduce these risks. All the time in a mortgage bond based system, the credit risk remains with the same institution that originated the loan. This ensures a very thorough assessment of the creditworthiness of the borrower, a very intense monitoring of the creditor after signing the contract and leaves little room for moral hazard. In the MBS system, the loan (including its risk) is sold to the special purpose vehicle (SPV). Thus, the loan originator (the bank) might not be as careful as in the alternative system when it comes to the assessment of the creditworthiness of a borrower. Effective and sophisticated auditing firms are needed for a rating of the mortgage pool. Besides, the possibilities for fraud are much higher in the MBS system. Thus we mark that the MB system has an advantage over the MBS system from the point of view of safety. At the same time the MB system creates few grounds for corruption in contrast to the MBS system that can stimulate it in the Belarusian reality.

The next criterion for changing a mortgage system in Belarus is a legal basis for each of the systems. Certainly, implementing either system will require significant amendments and improvement of the existing legislation. But the inclusion of a fourth participant (the SPV) into the system significantly increases the number and the complexity of the necessary legal contracts to run the system. This would certainly be a problem in a country such as Belarus with a poor record on law and contract enforcement.

Implementing a system based on capital markets will not be an immediate process. It will take time and there will be a transitional period for a housing finance market to develop. But in order to accelerate the implementation, a less complex system, which would incur fewer costs, should be chosen. An MBS system has the great disadvantage of being rather complex and requiring highly developed legal and financial institutions. When choosing the MB system Belarus would face the necessity of creating new institutions only in case of introducing a special banking principle. Thus comparing the two systems from this point of view we again conclude the MB system to be more advisable than the MBS one.

On the other hand the MBS system has got a unique advantage – a possibility of freeing banks' balance sheets from mortgage loans. That is why Belarusian banks might be supporters just of this system, legitimating it with more stability in the banking industry. They could argue that mortgage interest rates would include lower risk premia, so the loans would be more affordable for households. Actually the MBS system is unlikely to reduce the risk in the entire mortgage lending cycle, but leads to a better allocation of risk. It should be mentioned that the MB and the MBS system could co-exist. But initially all the efforts should be focused on a single system; the system that might become more effective and efficient in Belarus. We consider that the MB system should be the strategic choice.

5. Universal or Special Banking Principle - What is more in Demand for Belarus?

A universal banking principle means that any bank can grant mortgage loans. By contrast a special banking principle means that only specialized banks can conduct this activity. Those specialized mortgage banks are restricted in their activities (e.g. deposit taking, other loans, money transfer etc. are not allowed). The requirement appears mainly from the goal of safety and lowering the risk exposure. Frequently MB systems co-exist with the requirement of mortgage banks to be specialized, i.e. that only banks that are specialized exclusively on mortgage lending are allowed to issue mortgage bonds, not universal banks. But this unity is not necessary. We can classify the Belarusian system as universal one. According to the Banking Codex and the Regulation of NBB № 175 different types of banking activity should be licensed by NBB (6 different licensees). But there are no restrictions for receiving these licensees depending on banking activity peculiar to a specialist banking principle. All the requirements are concerned with economic figures (for instance, for being allowed to take deposits, a bank must have equity capital not less than 10 million Euro) and technical capacity of a bank.

The main argument for specialized mortgage banks is the creation of a very stable type of bank that can be supervised more easily than universal banks. To give these banks an incentive to grant mortgage loans and eventually to channel private savings into the housing market, they are exclusively allowed to issue mortgage bonds. This is supposed to lead to stable banks. But judging the systemic stability of a banking system it is doubtful, whether a specialized mortgage bank is more stable than a universal bank. Further, in the short run when capital markets begin to develop, a pure mortgage bank would have no sufficient funding base, therefore other instruments of refinancing should be allowed. Thus, when the advantage of specialized mortgage banks in terms of safety is not evident and the refinancing situation on capital markets is still tight in the case of Belarus, we conclude that universal banking is more preferable.

Table 1: New deposits by maturities (2002 / 2003)
(Share in total volume of deposits obtained, %)

Deposits' maturity	Share in total volume of deposits, %
Currents deposits	8
Under 1 month	45
Between 1-3 months	34
Between 3-6 months	6
Between 6-12 months	4
Between 1-3 years	3
More than 3 years	0

Source: National Bank and author's calculations.

The existing deposits are unlikely to be the source of refinancing because of their short-term maturities (see table 1). Banks trying to limit liquidity and interest rate risks are reluctant to grant long-term mortgage loans on the basis of short-term deposits.

But nevertheless banks can do a bit of maturity transformation. So allowing mortgage banks to take on deposits (universal banking system) will expand their funding base. Besides we can argue that universal banks are more profitable than specialized banks, because of unrestricted business activities. Universal banks evidently have a better risk diversification and hence are the more stable ones. Therefore even taking into account that deposits of the Belarusian banks are a minor source of funding mortgage loans we support the universal banking principle in Belarus.

6. What is Needed to Establish a Secure System?

Above we have slightly touched the role of the government and NBB in the system of mortgage lending. We marked our position that the government should enhance the safety of the system by regulation and supervision, without interfering into the decision-making of a mortgage credit institution. Thus the established economic requirements and restrictions should be the only tool when the system of mortgage lending is active.

In order to make the MB safe and attractive to investors, only bonds featuring specific safety standards should be allowed for circulation at the secondary mortgage market. The main safety mechanism is the "cover principle". Mortgage bonds should be covered at all times by mortgage loans at least equal to the nominal value of all outstanding issues and yielding at least an equal interest yield (i.e. that the interest rate for a mortgage loan granted should be the ceiling of an interest rate yield of a mortgage bond). Furthermore, cover assets should be first-charge mortgages.[2]

One more criterion that should be established by the government is the so-called "loan-to-value" ratio[3]. The higher the ratio the higher the credit risk is in the bank. On the other hand, a low loan-to-value ratio means that the borrower has to finance a bigger part of the house or apartment from own savings and makes it more difficult to bring borrowers and lenders together. In order to decide how to deal with this trade-off between safety and profitability, the main problem at the Belarusian bond market should be recalled: It is the lack of safe bonds. The priority should be the legal creation of safe bonds. Otherwise investors will not buy mortgage bonds and banks will not be able to collect long term refinancing from the capital market. Analyses showed that increasing the loan-to-value ratio resulted in bigger systemic risk. At 80% loan-to-value ratio this risk becomes much more significant, especially in case of transitional economies. Hence, we recommend limiting the loan-to-value ratio for mortgage loans, which are used for mortgage bonds, to 60%.[4]

Summarizing we recommend the following measures as strategic decisions for developing the mortgage lending system in Belarus:

1. The MB system should be preferred over the MBS system.
2. A universal banking principle should be maintained in Belarus and consequently there should not be a specialized type of mortgage banks.
3. The cover principle should be introduced into practice. A loan-to value ratio should not be set higher than 60%.

D.K., Ph.S. Lectors: R.G., A.Ch.

[2] A lender who has a first legal charge over a property will have the first call on any funds raised from the property sale.

[3] Loan-to-value ratio means the relation of the mortgage loan to the value of a house or an apartment purchased.

[4] This recommendation is based on the positive German experience of a 60% loan-to-asset ratio for mortgage loans, which are used to secure mortgage bonds.